

TEACHERS' RETIREMENT BOARD
BUDGETS AND AUDITS COMMITTEE

SUBJECT: Internal Audits Follow-up Status Report

ITEM NUMBER: 11

ATTACHMENTS: 1

ACTION: _____

DATE OF MEETING: November 7, 2002

INFORMATION: X

PRESENTER: Way Lee

In accordance with Internal Auditing Standards (IA Standards), we have taken steps to determine the adequacy, effectiveness, and timeliness of actions taken by management on reported audit engagement observations and recommendations (conditions). This includes conditions reported by CalSTRS' external auditors as well as those reported by the Office of Audits.

On Attachment 1 we have provided a report on the unresolved conditions from CalSTRS' internal and external audits. Unresolved conditions are those conditions for which management is in the process of implementing corrective action. The last column of the report identifies the current status of corrective actions taken by management in response to observations and recommendations.

IA Standards recognize that senior management is responsible for deciding the appropriate action to be taken in response to reported observations and recommendations and that management may decide to assume the risk of not correcting the reported condition because of cost or other considerations. CalSTRS' Audit Chief is responsible for assessing management's action and determining the nature, timing, and extent of follow-up procedures necessary. In determining appropriate follow-up procedures, the IA Standards allow the Audit Chief to determine whether management's oral or written response shows that action already taken by management is sufficient when weighed against the relative importance of the condition. On such occasions, follow-up testing or verification can be performed as part of the next audit of the program or activity in question.

At the request of the Board, we no longer report on those conditions that the Office of Audits has determined to be resolved. Resolved conditions are those for which management has effectively implemented corrective action or for which senior management or the Board has decided to assume the risk of not correcting the reported condition. We did have conditions that moved from an unresolved status to a resolved status during this quarterly reporting period. We also had resolved conditions related to new audits, for which we performed our initial follow-up on during this quarter. The applicable audit and the number for those newly resolved conditions are identified on the next page.

<u>Audit</u>	<u>Number of Conditions Moved To Resolved Status since July 2002</u>
Disability Benefit Application Process	1
Disability Benefits Audit	1
Inactive Member Accounts	1
Real Estate Preliminary Review	1
Internal Equities Preliminary Review	<u>14</u>
Total items moved to resolved status during quarter:	<u>18</u>

UNRESOLVED CONDITONS From CALSTRS' Internal & External Audit Engagements, Status as of 10/22/02

Auditee	Audit # / Audit Activity	Period Reviewed	Report Issue Date	Reported Condition	Resolution or Status of Reported Condition	F/Up Status
Office of Audits, Admin. Branch	External CPA's Management Report for the YE 6/30/01	FY 00/01	9/21/01	<i>Perform an Independent Post-Implementation Review of the START System:</i> An independent Post-Implementation Review should be conducted to assess the effectiveness of the development and implementation of CalSTRS' START project, so that necessary recommendations and improvements can be made for future projects.	Concur & in progress. A third-party consulting firm is in process of performing a review of the START System. The review is expected to be completed by December 2002.	A, C
Information Security Office Admin Br.	External CPA'S Management Report for the YE 6/30/01	FY 00/01	9/21/01	<i>Update and Complete Disaster Recovery and Business Plans:</i> CalSTRS' current disaster recovery and continuity plans appear to be incomplete and outdated.	Concur & in progress. Executive presentations have been completed and executive support attained. A Business continuity Steering Committee and a Working Group are under development and budget items are being identified. The committee will develop CalSTRS' Business continuity goals and objectives for the next three to five years. Assuming necessary resources are available, the corrective action should be complete by June 2003.	A, C

LEGEND for F/Up Status:

- A** - Management concurred with reported condition
- C** - Management is in the process of implementing corrective action

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Information Security Office, Admin Br. & ITSD, Information and Financial Services Branch, I&FS Br.				<p><i>Ensure Timely Revocation of Terminated Users' Systems Access and Physical Access to the Sacramento Data Center:</i></p> <ul style="list-style-type: none"> • System access for several users had been active for several weeks after their respective termination dates. • The security access control listing for CalSTRS' server room contained a large number of individuals authorized for physical access to the server room who no longer were employed by CalSTRS. 	<p>Concur & in progress.</p> <ul style="list-style-type: none"> • At this point, no front-end administrative changes have been made to the process of terminating users' system access. Currently, a departmental cross-functional policy team regularly meets to address this and other issues. A process is expected to be in place by June 2003. • ITSD staff performed a review (in the Fall of 2001) to identify all individuals that had access to the computer room. Access was deleted for many individuals, as deemed appropriate. ITSD staff also coordinated with Admin. Br. Staff to obtain and review a monthly listing of individuals that have approved, authorized access to the room. 	A, C

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ITSD, I&FS Branch	External CPA's Management Report for the YE 6/30/01	FY 00/01	9/21/01	<i>Improve Change Migration Procedures:</i> Formal test and user acceptance documentation standards do not currently exist for changes made to the START system. Without this monitoring procedure, untested or unauthorized changes may be permitted to negatively impact the production environment and data.	Concur & in progress. In January 2002, the ITSD staff conducted a management team meeting to review and improve the change migration procedures, primarily focusing on communication and documentation. As a result, a new form was developed and piloted. ITSD will be hiring a contractor to conduct a project to develop and implement improvements to the change control function. The contractor is expected to be in place by November 20, 2002.	A, C
Real Estate Div., Investments Branch	#A-00002 Real Estate Preliminary Review	FY 00/01	3/19/2002	<u>Section A</u> A.1. Real Estate Division (RED) staff developed "New" Real Estate Guidelines, during the period from October of 1999 to December 2000, that are currently in use but have not been formally reviewed and/or approved.	Concur & in progress. The Real Estate Division (RED) has created an approval memo document. The Director of Real Estate is reviewing the document for approval.	A, C

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				<p>A.2. Real Estate Guidelines have not been developed for joint ventures. In addition, Guidelines that had been developed for commingled funds were not incorporated into the Real Estate Manual.</p>	Concur & in progress. RED has addressed joint ventures and commingled funds in Guidelines 411, 411(a) and 412. The Director of Real Estate is reviewing the guidelines for approval.	A, C
				<p>A.3. The Guidelines are silent with regard to:</p> <ol style="list-style-type: none"> 1) How RED staff will monitor capital markets and, 2) How or when the CIO will communicate to the DRE the annual cash yield rate. 	Concur & in progress. RED has addressed these processes in Desk Procedures 5 and 15. The Director of Real Estate is reviewing the Desk Procedures for approval.	A, C
				<p>A.4. Property Managers use NCREIF methodologies to value real estate properties on an annual basis. RED should develop desk procedures to describe what</p>	Concur & in progress. RED has addressed valuation methodologies in Desk Procedure 16. The Director of Real Estate is reviewing the Desk Procedure for approval.	A, C

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				alternative procedures staff use to investigate material variances in property values.		
				A.5. There is no documentation of site-visit observations and the methodologies utilized to evaluate proposed medium and high-risk real estate acquisitions.	Concur & in progress. RED has addressed these issues in Desk Procedure 11. The Director of Real Estate is reviewing the Desk Procedure for approval.	A, C
				A.6. Real Estate Guidelines are silent with regard to the documentation of legal reviews.	Concur & in progress. RED has addressed legal reviews in Desk Procedure 12. The Director of Real Estate is reviewing the Desk Procedure for approval.	A, C
				A.7. The Investment Branch should assign staff to monitor the overall activities of the Real Estate Program. Specifically, the Investments Branch should centralize its databases of real estate transactions and implement a process to regularly	Concur & in progress. RED has addressed applicable processes in Guideline 540. The Director of Real Estate is reviewing the guideline for approval.	A, C

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				<p>verify the integrity of managers' reported data, to reconcile CalSTRS records with the managers' reports, and to follow-up on any discrepancies.</p> <p>A.8. RED does not reconcile its records with Investment Accounting records.</p> <p>A.9. Real Estate Guidelines are silent regarding procedures for "Portfolio" purchases of real estate. For example, the Guidelines do not address such issues as:</p> <ul style="list-style-type: none"> • What procedures should be followed regarding DD if properties are of mixed risk? • Is Discretionary Authority applicable for a portfolio of 	<p>Concur & in progress. RED has addressed record-keeping activities in Guideline 540. The Director of Real Estate is reviewing the guideline for approval.</p> <p>Concur & in progress. RED has addressed procedures regarding portfolio purchases in Guideline 430. The Director of Real Estate is reviewing the guideline for approval.</p>	<p>A, C</p> <p>A, C</p>

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				<p>mixed risk properties?</p> <p>In addition, during our review we noted that an Advisor under delegated authority purchased a portfolio of mixed risk properties.</p> <p><u>B Section: Real Estate Transactions Including Fees</u></p> <p>B.1. “Operational Audits”, Section 540 of the Real Estate Guidelines, has not been implemented with the exception of the annual financial audit of CalSTRS. Therefore, RED does not have assurance that financial data has been reported consistently or accurately because financial data is not reviewed and/or audited by an independent third party.</p>	<p>Concur & in progress. RED plans to implement reviews and/or audits in 2003, on a rotating basis for most assets. RED will also have the option of targeting specific assets or managers, as the needs dictate.</p>	<p>A, C</p>

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				<p>B.2. The definition of “Net Operating Income” (NOI), as applied by RED, is not consistent with Generally Accepted Accounting Principles (GAAP) or any other industry standard.</p> <p><u>Section C: Acquisition Fees</u></p> <p>C.2. Real Estate Guidelines do not give clear instructions how the “Purchase Price” should be derived and/or where it is documented.</p> <p>C.3. RED should develop in-house templates to be used by managers for the calculation of acquisition and disposition fees. The templates should standardize the interpretation and application of NCREIF.</p>	<p>Concur & in progress. RED has addressed NOI in Guideline 495. The Director of Real Estate is reviewing the guideline for approval.</p> <p>Concur & in progress. RED is in the process of developing guidelines regarding “Purchase Price” calculations and expects to complete them by December 2002.</p> <p>Concur & in progress. RED is in the process of developing in-house templates that will standardize the use of NCREIF methodologies. RED expects to complete template development by December 2002.</p>	<p>A, C</p> <p>A, C</p> <p>A, C</p>

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				<p>C.4. Property managers have developed their own processes to calculate the acquisition fee bonus. Their process is unnecessarily complex and contains extraneous information, which makes it difficult and confusing to review.</p> <p>C.5. Acquisition Fee performance criteria may not be consistent with CalSTRS' Real Estate Policy investment goals.</p> <p><u>Section D: Disposition Fees</u></p> <p>D.1. We reviewed one fee and found RED' Disposition Fee review did not have adequate supporting documentation. RED should review the application of Real</p>	<p>Concur & in progress. (Same as response above for C.3.).</p> <p>Concur & in progress. RED agrees with observation and expects to take action by December 2002.</p> <p>Concur & in progress. RED has addressed the disposition fee calculation and fee review process in Guideline 540. As indicated in C.3. above, RED is in the process of developing in-house templates that should be completed by December</p>	<p>A, C</p> <p>A, C</p> <p>A, C</p>

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				Estate Guidelines as well as verify financial data elements used in the disposition fee calculation.	2002.	
				D.2. PCA (CalSTRS' Independent Real Estate Consultant) may not have sufficient objectivity to perform a critical review and analysis of disposition fee billings because they were directly involved with the development of the methodologies and template used by advisors for the calculation of disposition fees. Therefore, RED should develop their own methodologies and template for the calculation of disposition fees to be used by all advisors.	Concur & in progress. (Same as response for C.3. above).	A, C
				D.3. Real Estate Policy – Guidelines	Concur & in progress. RED has addressed the	A, C

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				<p>are silent with regard to updating and/or adjusting the hurdle rate when and if the NCREIF index changes. In addition, Real Estate Guidelines do not address whether the hurdle rate should be the same for all property types and risk levels.</p> <p>D.4. Material dollar amounts could be accumulating over a ten-year period that may not be accurately disclosed in the financial statements.</p> <p>RED does not know whether the accounting and reporting of disposition fees is correct because they do not review and/or reconciliation their records with Investment Accounting.</p> <p>In addition, they do not review CalSTRS recording and</p>	<p>hurdle rate in Desk Procedure 3. The Director of Real Estate is reviewing the Desk Procedure for approval.</p> <p>Concur & in progress. These issues are addressed in Guideline 540. The Director of Real Estate is reviewing the guideline for approval.</p>	A, C

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				<p>accounting for real estate transactions with that of advisors. Consequently, key financial data elements, used to calculate disposition fees, which are provided by advisors, such as; cash flows, cost basis and sales price may be in error.</p> <p><u>Section E: Due Diligence</u></p> <p>E.1. Real Estate Guidelines do not address whether RED staff review and/or approve due diligence expenditures (DD budgets are approved) or how variances should be resolved.</p> <p>E.2. Advisors preparing pro forma financial projections and market studies may lack independence because they have a direct financial interest in new acquisitions. Therefore, Existing</p>	<p>Concur & in progress. RED has addressed Due Diligence procedures in Guideline 490. The Director of Real Estate is reviewing the guideline for approval.</p> <p>Concur & in progress. RED has addressed the review and approval process in Desk Procedure 5. The Director of Real Estate is reviewing the desk procedure for approval.</p>	<p>A, C</p> <p>A, C</p>

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				<p>Guidelines should be expanded to address how and when RED staff review and approve assumptions used in pro forma financial statements.</p> <p>E.3. RED is uncertain whether all contractors, used by Advisors, have a conflict of interest. Because some contract vendor personnel who are non-management are certifying that there is "No Conflict of Interest".</p>	<p>Concur & in progress. RED addressed Due Diligence expense monitoring, review, and reconciliation in Guideline 490. The Director of RED is reviewing the guidelines for approval.</p>	A, C

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Internal Equity Div., Investments Branch	#A-00003 Internal Equities Preliminary Review	7/99 to 3/01	3/19/2002	<p><u>A.1. Policies and Procedures</u></p> <p>The Desk Manuals lack detailed instructions for implementing the procedures developed by investment staff from the Board-approved policies. Detailed instructions should include narrative; flowcharts about daily processes and activities; and should also function as a training manual.</p>	<p>Concur & in progress.</p> <p>Detailed instructions for managing the Venture Capital Stock Distributions Program have been enhanced to reflect current processes. Daily, weekly and monthly tasks related to managing the portfolio have been documented.</p> <p>At the interception of the Russell 1000 Indexed Portfolio (formerly the S&P 500 Indexed Portfolio) in 1987, detailed instructions were created. Internal Equities is in the process of enhancing the comprehensive instructions for managing the internal indexed portfolio. Internal Equities goal is to complete the instructions by December 2002.</p>	A, C
				<p><u>A.2. Filings</u></p> <p>Neither the Incompatible Activities Statement nor Information Security Statement were on file for the IE Director within HR's personnel files nor</p>	<p>Concur & in progress. HR will ensure that Incompatible Activities Statements are completed, signed, and filed correctly. The ISO will work with HR to ensure a process is in place by December 31, 2002. The process will provide</p>	A, C

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				<p>with the Information Security Officer (ISO), respectively.</p> <p><u>D.3. Cash Forecast Reporting</u></p> <p>The Cash Forecast reporting process which applies to IE's S&P 500 Index-Ex Tobacco portfolio is affected by mechanical errors associated with IE's Proprietary Portfolio Management Reporting System. Procedures for cash forecasting work-flow and processes should be addressed in the Desk Manual.</p> <p><u>F.1. Disaster Recovery Plan</u></p> <p>CalSTRS' independent financial auditors recently reported to management that CalSTRS' agency-wide, Disaster Recovery (DRP) and Business Continuity plans are incomplete and</p>	<p>assurance that each employee receives, signs, and returns the Information Security Statement and that the statement is on file.</p> <p>Concur & in progress. See A.1. The Russell 1000 Indexed Portfolio (formerly the S&P 500 Indexed Portfolio) will include detailed instructions for the cash forecasting process.</p> <p>Concur & in progress. Internal Equities goal is to minimize operational risks that are associated with the portfolio management processes. To ensure this, Internal Equities intends to begin to develop a comprehensive disaster recovery plan. The target completion date for this plan is June</p>	<p>A, C</p> <p>A, C</p>

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				outdated. Those plans should include guidelines for the recovery of Investments Branch systems and operations.	30, 2003.	

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